Mercantilism in a Liberal World Order: 
The Origins of Persistent 
Current Account Imbalances

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Motivation

- Current account imbalances promote financial instability
- Deficits/surpluses persist over decades
- Exchange rate adjustment works for many countries (France, Italy, etc)...
- But fails for the US, UK, Australia, Canada, China, Germany, Japan, Sweden, Denmark, Switzerland, New Zealand & others.
Two examples

![Graph of Australia's Current Account (% GDP) from 1960 to 2010. The graph shows fluctuations around the years with a peak around 2000.]

![Graph of Japan's Current Account (% GDP) from 1960 to 2010. The graph shows fluctuations around the years with a peak around 2000.]

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Mercantilism
The Big Picture

Current account balance, % of GDP

# years in deficit

Portugal: 31 / 36
N. Zealand: 38 / 39
Greece: 34 / 34
Australia: 49 / 51
Israel: 43 / 56
Spain: 31 / 36
Canada: 33 / 41
USA: 47 / 61
UK: 30 / 41
Ireland: 26 / 37
Italy: 26 / 41
Austria: 28 / 44
France: 19 / 36
Sweden: 19 / 41
Korea: 16 / 35
Finland: 18 / 36
Denmark: 16 / 36
Germany: 16 / 61
Japan: 14 / 61
Netherlands: 2 / 44
Switzerland: 2 / 23

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Question

- Why do some countries persistently run current account surpluses and others persistently deficits?
- Why does adjustment via the real exchange rate fail to balance current accounts?
Stylized facts

- Some countries have centralized, coordinated wage bargaining (CWB) institutions, others decentralized wage setting institutions (cf. Varieties-of-Capitalism literature)
- CWB countries have high real exchange rates
- But their real exchange rates appreciate relatively slowly
- CWB countries “correct” quickly to long-term equilibrium after external shocks
Example Germany and Reunification as Exogenous Event

- **Real Exchange Rate**
  - Wage compression phase
  - PPP/XR of GDP output, USA in 2005=1

- **Current Account**
  - (% of GDP)

**Years:** 1980, 1990, 2000, 2010
Institutional Equilibrium: The Upside

- Exporting firms have no pricing power in foreign markets
- CWB institutions can enforce industry-wide wage settlements
- Wage settlements do not exceed productivity gains
- Real exchange rates appreciate slowly
- Competitiveness is maintained and exports boom
Institutional Equilibrium: The Downside

- Wage compression creates reverse Balassa-Samuelson effect
- This threatens to reduce wages in non-tradable sector
- So non-tradable sector responds by creating barriers to entry
- Tradable sector subsidizes wages in non-tradable sector
- Services sector remains protected, worsening trade imbalances
Wage bargaining centralization and trade and current account balances

\[ y = -4.81 + 13.57 \cdot x \]

\((2.08) \ (5.35)\)

\[ y = -4.81 + 13.57 \cdot x \]

\((1.97) \ (5.08)\)
Wage bargaining centralization, $\Delta$ real exchange rate, and the current account

\[ y = 0.0142 + -0.03135 \cdot x \]

\[ (0.004) \quad (0.010) \]

\[ y = -0.195 + -221.8 \cdot x \]

\[ (0.62) \quad (63.30) \]
Short-run ECM and long-run linear model: Variables

**Dependent variable:** Trade balance or current account balance in year $t$ or five-year average, all relative to GDP

**Independent variable:** Wage bargaining centralization

**Controls variables:**

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description</th>
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<tbody>
<tr>
<td>Real exchange rate (PPP/XR)</td>
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<tr>
<td>Labour compensation/GDP</td>
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<td>Dependency ratio</td>
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<td>Foreign reserve balance/GDP</td>
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<td>$\Delta$ total factor productivity</td>
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<td>Fuel exports share/GDP</td>
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<td>Fiscal balance/GDP</td>
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<td>Net foreign assets/GDP</td>
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Findings

- Lagged wage bargaining centralization score correctly signed, significant, substantively large in trade balance models
- $\Delta$ real exchange rate negatively affects external balances
- More fragile results for full current account model with lagged dependent variable ($\approx \Delta$ net foreign assets)
- Greater labour compensation share in GDP reduces surpluses
- Other control variables behave as expected
Long-term effect of a standard deviation increase in centralization; bootstrapped 95% confidence intervals.
Centralized wage bargaining institutions permit wage compression (but perhaps only with closed service sector)
Wage compression sustains current account surpluses
Not a policy variable: hard to change in short run
More promising: open service sector in CWB countries